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19039—24†—1

In the Supreme Court of the United States

OCTOBER TERM, 1924

NATIONAL PAPER AND TYPE COMPANY, plaintiff in error
v.
FRANK K. BOWERS, COLLECTOR OF INTERNAL REVENUE for the Second District of New York, defendant in error } No. 320

BARCLAY AND COMPANY, INC., PLAINTIFF in error
v.
WILLIAM H. EDWARDS, COLLECTOR OF Internal Revenue for the Second District of New York, defendant in error } No. 547

WRITS OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR THE DEFENDANTS IN ERROR

STATEMENT OF FACTS

These two cases, although arising under two different Revenue Acts, involve substantially the same questions.

The questions are:

1. Do the Revenue Acts of 1918 and 1921, which impose a tax on the net income of all corporations, violate Article I, section 9, clause 5, when applied to corporations, whose business is the manufacture or purchase within the United States of articles afterwards sold to purchasers without the United States?

2. Do those Revenue Acts, which, while taxing such income of domestic corporations exempt from taxation the income of nonresident foreign corporations which manufacture and purchase property within the United States and sell it without this country, contravene the due process provision of the Fifth Amendment?

The district court dismissed the complaints on the ground that they do not state facts sufficient to constitute a cause of action, basing its decision on *National Paper and Type Company* v. *Edwards*, 292 Fed. 633. (The opinion in that case is printed in the records at pages 6–8.) The cases were then brought to this court on writs of error.

The plaintiff in No. 320 was a domestic corporation, engaged in the business of purchasing personal property within the United States and selling it without the country. Taxes on its net income for its fiscal year ending March 31, 1921, were assessed against and collected from it. The suit is to recover

back only the tax for January, February, and March, 1921, levied under the provisions of sections 205 and 230 of the Revenue Act of 1921 (42 Stat. 227, 232, 252). The first three of the quarterly payments (which are not herein involved) were governed by the Revenue Act of 1918. Payment of the taxes for the fourth quarter was made under protest, claim for refund thereof was duly filed, and the Commissioner of Internal Revenue having rendered no decision thereon within six months, suit was brought to recover back those taxes. The complaint alleged that the taxes on the income derived from the business of purchasing property within the United States and selling it without the United States were a direct burden on the business of exporting and therefore in violation of Article I, section 9, clause 5, of the Constitution. And it further alleged that, inasmuch as, under sections 217 and 233 of the Revenue Act of 1921, nonresident foreign corporations are exempt from tax on net income derived from such business, the taxation of the plaintiff was a taking of its property in violation of the Fifth Amendment.

In No. 547 the plaintiff alleged that it was a domestic corporation manufacturing personal property within the United States and selling it without the United States. Taxes were assessed against it on the income earned during its fiscal year ending December 31, 1918. Of these taxes the plaintiff paid $8,000 under protest on March 14, 1919. It alleges that of this sum $7,600 represented income or profits derived by it from its manufacture of goods within

the United States by the plaintiff and its exportation and disposition of those goods in foreign countries. This suit is to recover back that $7,600, which was assessed and collected under sections 230 and 301 of the Revenue Act of 1918 (40 Stat. 1057, 1075, 1088). Claim for refund of that sum was duly filed, and, the Commissioner of Internal Revenue having rendered no decision the eon within six months, suit was brought to secure the refund. The complaint alleged that the taxes on the net income derived from the manufacture of goods within the United States and their sale without the United States were invalid for the same reasons as those suggested in the first case.

THE STATUTES

The pertinent provisions of the two Revenue Acts are as follows:

REVENUE ACT OF 1918

> SEC. 230. (a) That, in lieu of the taxes imposed by section 10 of the Revenue Act of 1916, as amended by the Revenue Act of 1917, and by section 4 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:
>
> (1) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 236; and * * *. (40 Stat. 1075, 1076.)
>
> SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions al-

lowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226. (40 Stat. 1077.)

SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in section 213, except that: * * *

(b) In the case of a foreign corporation gross income includes only the gross income from sources within the United States, including the interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States. (40 Stat. 1077.)

SEC. 301. (a) That in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by this Act, there shall be levied, collected, and paid for the taxable year 1918 upon the net income of every corporation a tax equal to the sum of the following:

FIRST BRACKET

30 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

THIRD BRACKET

The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets. (40 Stat. 1088.)

REVENUE ACT OF 1921

SEC. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1920 and ending in 1921, his tax under this title for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1918 at the rates for the calendar year 1920 which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1921, which the portion of such period falling within the calendar year 1921 is of the entire period. (42 Stat. 232.)

SEC. 230. That, in lieu of the tax imposed by section 230 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; and * * *. (42 Stat. 252.)

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217. (42 Stat. 254.)

SEC. 217. (a) That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262 * * *.

(c) Items of gross income, expenses, losses, and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the Commissioner with the approval of the Secretary. * * * Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, shall be treated

as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from the country in which sold. * * *. (42 Stat. 243, 244, 245.)

Sec. 233. * * *.

(b) In the case of a foreign corporation, gross income means only gross income from sources within the United States, determined (except in the case of insurance companies subject to the tax imposed by section 243 or 246) in the manner provided in section 217. (42 Stat. 254.)

ARGUMENT

I

A tax upon net income is not a tax upon exportation even if the income is derived from the manufacture or purchase of goods within the United States and their sale without the United States

That a general tax upon net incomes is not a tax upon exports forbidden by the Constitution when laid upon a net income derived from exportation has been definitely settled by this court. In the case of *Peck & Co.* v. *Lowe*, 247 U. S. 165, it held that the tax imposed by Section II of the Act of October 3, 1913, upon all net incomes over a certain amount was not unconstitutional when imposed upon the net income of a taxpayer derived from exporting articles from

the United States. The court says, in its opinion at pages 174–175:

> The tax in question is unlike any of those heretofore condemned. It is not laid on articles in course of exportation or on anything which inherently or by the usages of commerce is embraced in exportation or any of its processes. On the contrary, it is an income tax laid generally on net incomes. And while it can not be applied to any income which Congress has no power to tax (see *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 113), it is both nominally and actually a general tax. It is not laid on income from exportation because of its source, or in a discriminative way, but just as it is laid on other income. The words of the act are "net income arising or accruing from all sources." There is no discrimination. At most, exportation is affected only indirectly and remotely. The tax is levied after exportation is completed, after all expenses are paid and losses adjusted, and after the recipient of the income is free to use it as he chooses. Thus what is taxed—the net income—is as far removed from exportation as are articles intended for export before the exportation begins. If articles manufactured and intended for export are subject to taxation under general laws up to the time they are put in course of exportation, as we have seen they are, the conclusion is unavoidable that the net income from the venture when completed, that is to say, after the exportation and sale are fully consummated, is like-

> wise subject to taxation under general laws. In that respect the status of the income is not different from that of the exported articles prior to the exportation.

At the same term this court upheld the Wisconsin income tax when applied to incomes derived from interstate commerce. The prohibition against a federal tax on exports contained in the Constitution is much narrower than the prohibition against the regulation of interstate commerce by the States. A State may not regulate interstate commerce by taxation, licenses or in any manner whatever, and all transactions which form an inherent part of such commerce must likewise be free from such regulation. Congress on the other hand is forbidden only to lay a tax on articles exported from any State, and this has been construed as prohibiting merely a tax upon the act of exportation or any of the necessary processes or instrumentalities thereof.

Despite this sweeping prohibition of the regulation of interstate commerce by the States, this court held in *United States Glue Co.* v. *Oak Creek*, 247 U. S. 321, that a State, in laying a general income tax, may include in the computation of net income gains derived from transactions in interstate commerce without contravening the commerce clause of the Constitution.

The court said, at pages 328–329:

> The difference in effect between a tax measured by gross receipts and one measured by

net income, recognized by our decisions, is manifest and substantial, and it affords a convenient and workable basis of distinction between a direct and immediate burden upon the business affected and a charge that is only indirect and incidental. A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference between profit and loss, or to so diminish the profit as to impede or discourage the conduct of the commerce. A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax can not be heavy unless the profits are large. *Such a tax, when imposed upon net incomes from whatever source arising, is but a method of distributing the cost of government, like a tax upon property, or upon franchises treated as property;* and if there be no discrimination against interstate commerce, either in the admeasurement of the tax or in the means adopted for enforcing it, it constitutes one of the ordinary and general burdens of government, from which persons and corporations otherwise subject to the jurisdiction of the States are not exempted by the Federal Constitution because they happen to be engaged in commerce among the States. [Italics ours.]

It must, therefore, be taken to be settled law that a tax on net income derived from exportation is not a tax upon exports forbidden by the Constitution. These cases conclusively dispose of any contention that Congress had no power to levy the taxes imposed in the case at bar. These are general taxes on net incomes, imposed under the authority of the Sixteenth Amendment, and tax the articles exported by plaintiffs or on the exportation thereof no more than any other income tax does. Nor does the fact that the taxes are heavy in any way change its nature. If the taxes are such as Congress had power to impose the question of the rate of taxation is exclusively for Congress.

The fact that the taxes are heavy does not make it a direct burden on exportation, since they are imposed only on the profit derived from the transaction after exportation is completed, when the taxpayer is free to dispose of the profits as he sees fit. Unless the profits are large the tax can not be great, and if large profits are made they may be compelled to bear their share of the expenses of the Government, in such proportion as Congress may see fit. On no theory can the taxes here complained of be declared void as being within the constitutional prohibition of a tax on exports.

II

In taxing the net income of domestic corporations derived from the purchase or manufacture of personal property within the United States and the sale thereof without the United States, and at the same time exempting nonresident foreign corporations from such tax, Congress did not violate the Fifth Amendment

The plaintiffs contend that the exemption of nonresident foreign corporations from such taxes constitutes such a discrimination against domestic corporations; and that so far as the plaintiffs are concerned, these Revenue Acts are arbitrary, oppressive, and capricious, and, therefore, violate the due process clause of the Fifth Amendment.

The taxing power of Congress has three, and only three, express limitations—(1) Congress may not tax exports, (2) direct taxes must be apportioned among the States according to population, (3) indirect taxes must be uniform throughout the United States (by which phrase only geographical or territorial uniformity is meant)—and one implied limitation—Congress may not tax the States, or any governmental agency, instrumentality, or function thereof. Nothing is better settled than that the Fifth Amendment is not a limitation on the taxing power of Congress.

As this court said in *Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1, 24:

> So far as the due-process clause of the Fifth Amendment is relied upon, it suffices to say that there is no basis for such reliance

since it is equally well settled that such clause is not a limitation upon the taxing power conferred upon Congress by the Constitution * * *.

To the same effect are *License Tax Cases*, 5 Wall. 462; *United States* v. *Singer*, 15 Wall. 111, 121; *Knowlton* v. *Moore*, 178 U. S. 41, 87; *Patton* v. *Brady*, 184 U. S. 608, 617–620; *McCray* v. *United States*, 195 U. S. 27, 59, 63; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 158; *Billings* v. *United States*, 232 U. S. 261, 282; *United States* v. *Doremus*, 249 U. S. 86, 93.

These cases establish conclusively that if Congress is exercising the taxing power, and not under the guise of taxation attempting to do indirectly what it is forbidden to do directly, its acts can not be invalidated under the Fifth Amendment. The only uniformity required of Congress in imposing taxes is the territorial uniformity in regard to duties, imports, and excises, and no contention can be made that the income and excess profits taxes imposed under the challenged acts are not geographically or territorially uniform; that is, do not apply uniformly in all parts of the country.

That they do not burden all taxpayers equally does not make them territorially not uniform. That they apply to all domestic corporations and not to all partnerships can not render them void under any clause of the Constitution, since the distinction between corporations and partnerships is a well recognized one and a classification which Congress has power to make.

That the taxes are imposed on domestic corporations in respect to their income from all sources and on foreign corporations in respect only to their income from sources within the United States, even though the two classes of corporations may be engaged in exactly similar businesses, is not a valid ground for attacking the legality of the taxes. In the cases at bar the income of neither class of corporations is from sources within the United States, but from sources within foreign countries, since it is derived from the sale of goods exported from the United States in foreign countries. Under such circumstances it is quite proper for Congress to distinguish between domestic and foreign corporations, since the basic circumstances are different. It is an ancient maxim that taxes are the correlative of protection. The United States furnishes protection to its own corporations in all their dealings abroad; it does not furnish such protection to foreign corporations as to their extraterritorial operations.

Plaintiffs, American corporations, export and sell goods abroad with the assurance of the United States that they will receive redress for any injury that they may receive in any foreign land. This is not the case with a foreign corporation. If it exports goods from the United States and sells them abroad, it must look to the country of its origin for protection against injury and redress of loss and not to the United States. The entirely different relations in which the two classes of corporations stand towards the United States warrants the difference in treat-

ment in regard to taxation. The plaintiffs and all other domestic corporations pay a tax on their income from all sources, since that income is always earned under the protection of the United States and they have always the right to call upon the United States to protect their interests and redress their wrongs in whatever part of the world their business may take them. Foreign corporations are taxed only on their income from sources within the United States because only that income is earned under the protection of the American laws.

The classification of domestic and foreign corporations for purposes of taxation is not an arbitrary one. It is based on a very fundamental difference between the two and is one which even the States under the equal protection clause of the Fourteenth Amendment would have power to make—much more so Congress, which is subject to no such equal protection requirement. The case comes squarely within the ruling of this court in *LaBelle Iron Works* v. *United States*, 256 U. S. 377, wherein the court said at pages 392–393:

> The Fifth Amendment has no equal protection clause; and the only rule of uniformity prescribed with respect to duties, imposts, and excises laid by Congress is the territorial uniformity required by Art. I, Sec. 8 * * *. The difficulty of adjusting any system of taxation so as to render it precisely equal in its bearing is proverbial, and such nicety is not even required of the States under the equal protection clause, much less of Congress under

> the more general requirement of due process of law in taxation. * * * The act treats all corporations and partnerships alike, so far as they are similarly circumstanced. * * * If in its application the tax in particular instances may seem to bear upon one corporation more than upon another, this is due to differences in their circumstances, not to any uncertainty or want of generality in the tests applied.

The distinction between the taxation of citizens upon income derived from all sources and of aliens upon income only from sources within the United States has been recognized in all the Federal income tax acts from the Act of August 5, 1861 (12 Stat. 309), down to the Revenue Act of 1921. (*Shaffer* v. *Carter*, 252 U. S. 37, at pages 53, 54.) The comity of nations requires it. It is a fundamental distinction and one which the States must observe under the Fourteenth Amendment to the Constitution, for under that Amendment a State may tax a nonresident only on income derived from sources within its borders. (*Shaffer* v. *Carter, supra; Travis* v. *Yale & Towne Mfg. Co.*, 252 U. S. 60.)

To argue that Congress *must* disregard this distinction under penalty of want of due process of law in taxation is indeed a remarkable contention. It has no basis either in principle or authority.

While there can be no doubt that Congress might under guise of an excise tax on the privilege of doing any business in this country require all foreign corporations exporting goods therefrom to pay a tax meas-

ured by the amount of net income derived from the sale of goods so exported, there is great doubt of the jurisdiction of Congress to tax directly the income of a nonresident alien derived from sources within foreign countries. To attempt to impose such a tax would be to attempt to tax a subject beyond the jurisdiction of the United States, and an exaction of that kind, if it could be enforced, would not only be an abuse of the taxing power but destructive of our commercial intercourse with other nations. Recognizing this situation, Congress has not attempted to tax income of nonresident aliens or of foreign corporations from sources outside the United States, and plaintiffs insist that unless it does so, or imposes some other kind of tax which will equalize the burden on all foreign corporations engaged in a similar business, Congress may not tax its income at all. To state this proposition is to refute it.

As shown by the cases above cited there is no requirement in the Constitution that tax burdens shall be equal provided that they operate with geographical uniformity on all persons similarly situated. That these taxes do so can not be denied.

No argument can reasonably be made that in enacting these statutes Congress was not exercising the taxing power but attempting to enrich foreign corporations engaged in the export trade at the expense of domestic corporations or to drive domestic corporations out of that business. The Revenue Acts clearly show that they were designed solely for the purpose of raising revenue and had no ulterior motive

behind them. But if Congress was exercising the taxing power, then none of the limitations imposed upon this power by the Constitution has been overstepped. Foreign corporations, whose situation is fundamentally different, are classified and treated differently from domestic corporations. The classification is neither arbitrary nor unjust.

The fact that by reason of such classification foreign corporations have a lighter tax burden, so far as this country is concerned, than domestic corporations may be the proper subject for an appeal to Congress, but is not a ground for declaring the taxes to be void.

Respectfully submitted.

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